STATE OF CALIFORNIA

ARNOLD SCHWARZENEGGER, *Governor*

PUBLIC UTILITIES COMMISSION
505 VAN NESS AVENUE
SAN FRANCISCO, CA 94102-3298

April 3, 2007

RE: Rates of Return and Rates of Margin for Class C and D Water Utilities

TO: COMMISSION

This memorandum updates the Water Division's (WD) recommended rates of return and rates of margin for Class C and D water utilities, as required by D.92-03-093 in Phase I of I.90-11-033 (Water Risk OII). These updates have been calculated in accordance with Resolution W-4524, which revised the Standard Practice that addresses how the rate of return and rate of margin are calculated for Class C and D water utilities.

WD considered a number of factors in determining the rates of return, including the movement in actual and forecast interest rates over the last year (slightly higher short-term and lower long-term rates), the high operational risks faced by Class C and Class D water utilities, and the slightly higher authorized rates of return for Class A water utilities in 2006 over 2005 (average of 8.94% in 2006 versus average of 8.73% in 2005).

In determining the rates of margin, WD considered the most recent authorized average rate of return for Class B water utilities (10.25% in 2006), the most recent Class B rates of margin for the same period (15.19% in 2006), and the recommended rates of return for Class C and D water utilities.

For 2007, WD recommends that the following rates of return and rates of margin be used for Class C and Class D water utilities informal general rate cases (supporting documentation is attached):

	Rates of Return (ROR)	Rates of Margin
Class C	**12.10% to 13.10%**	**19%**
Class D	**12.85% to 13.85%**	**20%**

If you have any questions regarding the Rates of Return or Rates of Margin recommendations, please contact Sean Wilson of the Water Division (1-415-703-1818, smw@cpuc.ca.gov).

Sincerely,

Kevin P. Coughlan
Director, Water Division

Kayode Kajopaiye,
Chief, Utility Audit, Finance, &
Compliance Branch

Attachment

SUMMARY OF DATA USED IN DETERMINATION OF CLASS C & D RATES OF RETURN AND RATES OF MARGIN

- Class C water utilities have 2,000 or less customers.
- Class D water utilities have 500 or less customers.
- Pursuant to D.92-03-093, Ordering Paragraph 8, Water Division (WD) is directed to calculate rates using both return-on-ratebase and operating ratio methods of ratemaking for Class C and Class D water companies and recommend the rate method that produces the higher result. This same decision permits the rate of return to be set at a level above or below the recommended ranges, if warranted by the facts of a particular case.
- Use of the Rate of Margin in the development of a revenue requirement is an alternative method used where little or no rate base exists, the case for many of the Class C and D water utilities. The Rate of Margin is applied to Operating Expenses to determine the estimated dollar return that is then compared with the average dollar Rate of Return on rate base.
- WD estimates the Rate of Margin for Class C and D water utilities based on the assumption that there is a comparable relationship between Class B Authorized Rates of Return and Rates of Margin and Class C and D Authorized Rates of Return and Rates of Margin. WD makes this comparison because the Class B water operations, finances, and risks are more similar to those of the Class C and D water companies than with the much larger Class A water utilities.

Data Used In The Determination Of The Rates Of Return And Rates Of Margin

Year	Recommended ROR Range		Actual Interest Rates from the Federal Reserve			
	Class C Water	Class D Water	90-day Treasuries	1-Year Treasuries	5-Year Treasuries	Long-Term Treasuries
2005	11.90% - 12.90%	12.65% - 13.65%	3.22%	3.62%	4.05%	4.64%
2006	12.00% - 13.00%	12.75% - 13.75%	4.85%	4.94%	4.75%	5.00%
2007 (As of 02/07)	12.10% - 13.10%	12.85% - 13.85%	5.18%	5.05%	4.67%	4.89%
			Forecast Interest Rates from DRI			
Forecast for 2007 (As of 02/07)			5.09%	5.05%	4.83%	4.96%

Calculation of Rate of Margin	Inputs	Class C ROM	Class D ROM
Avg Class B Rate of Margin (ROM)	15.19%		
Avg Class B Rate of Return (ROR)	10.25%		
Avg Class C ROR	12.60%		
Avg Class D ROR	13.35%		
Avg Class C ROM = Avg Class B ROM * (Avg Class C ROR/Avg Class B ROR)		19%	
Avg Class D ROM = Avg Class B ROM * (Avg Class D ROR/Avg Class B ROR)			20%